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TAGS: ECON EFIN EINV ENRG EPET TRSY IN
SUBJECT: INFLATION, INTEREST RATES, AND GROWTH IN INDIA

¶1. Summary: In recent weeks, the Reserve Bank of India has raised the main monetary policy rate over 75 basis points in order to fight rising inflation. At the same time, India's main stock market indicator, the Sensex, has continued its slide, and is now almost 38 percent off its January 2008 peak. With a rising import bill widening India's current account deficit, the rupee has continued to depreciate, exacerbating the inflationary impact. Analysts and market players in Mumbai are settling in for slower growth and activity, and expect this period to last for at least the next six months. While they acknowledge that the RBI is right to raise rates to fight inflation, there is major concern about the increase in government spending, which is also contributing to inflation and has not been reigned in. With credit becoming more expensive, and most equity issuance drying up, analysts think that Indian companies will have to rely on their "structural tailwind" to ride out the troubles in the economy over the next few months. Nevertheless, at 7 plus percent growth, India is still growing at a relative premium to much of the rest of the world, even if this rate is not enough to fuel the kind of overall economic transformation its leaders want. End Summary.

RBI Raises Rates to Fight Inflation

¶2. On June 24, the Reserve Bank of India (RBI) unveiled a two-pronged strategy to combat inflation. The RBI raised the repo rate by 50 basis points (bps) to 8.50 percent. (Note: The repo rate is the rate at which RBI injects liquidity in the system. The RBI had raised the repo rate by 25 bps on June 11. End Note.) The central bank also raised the Cash Reserve Ratio (CRR), the proportion of deposits that banks need to maintain with the central bank, by 50 bps to be effective in two tranches-- 8.50 percent from the fortnight starting July 5 and 8.75 percent from July 19. This move came in four days after inflation, measured by the wholesale price index (WPI), touched a 13-year high of 11.05 percent for the week ended June 7. The RBI said these moves were intended to fight inflation and establish price stability, while still not stalling growth. In its explanation, the RBI also resolved to "respond swiftly on a continuing basis to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial stability and growth momentum, with both conventional and unconventional measures, as appropriate." The RBI had already acted to address inflation concerns by raising the CRR three times in April and May 2008.

¶3. Analysts and observers in Mumbai largely concurred that while initial inflation was due to a raise in domestic food and metals prices, the current high inflation is largely "imported;" the rising price of oil is having an impact not only in the crude that India must import as fuel, but also in many of the major products India needs, such as edible oils. The

depreciation of the rupee over the last six months has made this global trend more expensive, as the rupee has decreased in value against the dollar roughly 10 percent from January. In addition, India's major stock markets have continued on a slow, downward slide since their January 2008 highs, amidst some volatility. From its peak of 21,206 in January 2008, the Sensex, one of India's two major market barometers, is now hovering just below 13,000, a decline of 39 percent and a 15-month low. One of the reasons for this decline, besides expectations of slower growth, is the exit of foreign institutional investors (FIIs). FIIs brought in over $17 in portfolio capital in 2007, but have been net sellers so far this year, withdrawing approximately $6.44 billion to date.

¶4. Analysts and economists in Mumbai told Congenoffs that the RBI has clearly embarked on a tightening phase after high inflation took the bank - and everyone else - by surprise. Atsi Sheth, Chief Economist for Reliance Equities, expected that, despite the recent decrease in domestic food prices due to an above average harvest, inflation will remain high for several more months due significantly to the oil price pass through, but also rising prices for imported or manufactured food (such as edible oils) and from steel and cement, whose manufacturers still have potent pricing power.

¶5. As for the performance of the RBI, she said that had higher oil prices and commodity-led inflation not hit so suddenly, the bank may have been able to cut rates to stem slowing growth. Up until that point, the bank still had flexibility, but it now had to raise rates to fight inflation instead. Stating that much of the inflation is imported, she suspected that the RBI would try to use the rupee to fight inflation, but given the consistent capital outflows, the RBI would not be able to coax the rupee beyond 43/dollar; pushing it to 42/dollar would be "an uphill battle" and send the wrong market signals, she said. She estimated that the economy would continue to slow until December, after which things would likely pick up, including interest from foreign institutional investors.

¶6. Sachchidanand Shulkla, Economist at Enam Securities, a major Indian brokerage, expected inflation to be in the double digits for the whole of July and August, with some moderation seen from September onwards. He expected another 25 bps repo hike or, if liquidity is substantial, another CRR hike in July. He agreed with the market view that the RBI had fallen behind the curve, and that the impact of the RBI's efforts on inflation would be reflected only after September. Inflation may also ease then due to the expected bumper crop, helped by improvements in logistics and food distribution. He added that barring the edible oil segment in the WPI, most food prices were moderating. He averred that since this is an election year, however, the government would not allow further oil price rises to pass through to the public.

¶7. Indranil Pan, Chief Economist for Kotak Mahindra Bank, applauded the RBI for not "giving into market expectations" (cutting interest rates when the Fed was doing so) but still felt that the Central Bank could have moved faster. He expected the RBI to raise the repo rate by another 25 bps to indicate to the market that they are not yet done fighting inflation. He stated that the impact of these policy decisions on economic growth wouldn't be seen for at least one year. More hawkish, the director of research for Merrill Lynch, Indranil Sen Gupta, argues that the RBI will have to continue to raise the CRR and the repo rate, and take a much tougher stance over a longer period to turn the inflationary tide. In a recent research paper, Tushar Poddar of Goldman Sachs agreed, and expects that with inflation continuing in the double digits until the end of 2008, the RBI will raise the policy rate and CRR again.

Corporate Financing Costs Rise..

¶8. Sheth told Congenoff that companies are finding credit harder and more expensive to get, but those who want growth capital can still get it. Companies who want growth capital are still riding a "structural tailwind" provided by the previous

growth cycle. Infrastructure firms, however, are still growing, as the long-term demand makes these projects sensible, if perhaps slightly more expensive. Separately, the CEO of Ispat Energy expressed his view that only short-term financing costs had risen as compared to long-term financing. With energy costs so high, it was viable for them to undertake any energy-saving or power production project. "In the current climate only individuals and businesses that were heavily invested/ dependent on the stock market were affected", he added. However, Jamshed Irani, Director of Tata Sons, told Congenoffs that increasing cost of financing is holding them back on new projects.

¶9. Chetan Modi, India's Moody's representative, said that corporate India's true state will be revealed at the end of July, when quarterly earnings are released, but believed that companies will likely acknowledge a cut-back in capital expenditures. He expected that credit growth will slow considerably, and that banks may have to take a "benign view" of struggling companies and potential non-performing loans.

¶10. With the price of credit rising, and most foreign debt options closed off, Pan said that Indian companies would likely rely on accumulated internal surpluses rather than looking to banks or other sources of credit. He pointed out that the Treasury departments of many companies had used their ample cash reserves to generate profits in the market, and companies would now have to put this capital back into their business. However, he highlighted that most infrastructure companies and SME were still deprived of funds. Shukla predicted that while the balance sheets of Indian corporates were sound, they would adopt a 'review and wait' strategy, stalling new projects.

¶11. The Managing Director of PriceWaterhouseCoopers also told Congenoff that while new activity by Indian corporates has slowed significantly, PWC is much more active in serving foreign clients interested in Indian public or private equity investments. M.K. Sinha, the President of IDFC's Private Equity Infrastructure Fund, observed that U.S. investors are hesitant to enter new asset classes, such as infrastructure, but there is still a great deal of interest in private equity investments in India, now that valuations are much less expensive. He added that Indian infrastructure companies are eager to attract private equity investments, as it is too difficult to raise equity on the markets and debt is more expensive.

And Growth Will Slow in Many Areas..

¶12. Sheth told Congenoff that companies, especially auto, financial services, and consumer goods companies, are slowing down to reflect a slowing growth cycle and responding - rightly, she believes - to the wider economic and monetary policy signals. According to Pan, 9-10 percent annual growth was never sustainable. Despite slumping markets and growth, he forecast that the growth figures wouldn't fall drastically below 7 percent, due largely to the service sector's ability to "buffer the downside risk." He stressed that India always had a trade deficit, but successive India governments "never focused on it." He added that India's exports are almost equal to India's non oil imports; but with oil imports constituting almost 30-35% of the import bill, he predicted that for every 10 dollar increase in oil prices, the trade deficit would widen by about $800 million.

¶13. Shukla argued that even if only half of expansion plans were put on hold, growth would still remain significant. Shukla felt that high oil prices were due to speculative interest, not supply shortages, and that demand would slacken as growth in India and China slowed. He predicted that India's GDP would still grow at around 7.8-8.0 percent for FY09, as policy measures gradually take hold. Similarly, he expected that FII interest would return after October, prompting another rise in equity markets. However, he cautioned that should oil prices continue to rise, growth and markets would take much longer to recover.

Though Some International Investors Losing Interest
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¶14. Overall, Modi said that international markets are "turning against India," looking at the country more critically and giving greater weight to political risk. Modi commented that India's leaders have missed many opportunities to introduce reforms that would lock in growth; while he expressed sympathy for the challenges of India's leaders, he said "India's leaders have sat on their hands and basked in the international adulation." Without a continual stream of reforms, he suggested that "India's baseline growth is probably below 7 percent."

¶15. The head of equities for Goldman Sachs agreed that foreign investors are pricing in greater political risk for India, more in line with other emerging markets. He said that India's market should have begun to fall in line with other Asian markets in September and October, but the ongoing confusion over Participatory Notes made some investors wary of selling immediately, for fear that they could not come back in later. Pointing out that $6.5 billion has already flowed out of India this year, he said "this could easily double this year," as Indian markets remain expensive. He reported that many Indian companies are cancelling or putting on hold expansion projects, especially in real estate investments.

Fiscal Deficit A Major Concern

¶16. Market analysts continue to worry about India's growing fiscal deficit, citing a wave of ongoing and upcoming expenditures - including a national election within the year -- as a major problem for both inflation and fiscal health. Pan estimates that all planned expenditures - oil and fertilizer bonds, farm waivers, and higher salaries due to the pay commission recommendations - would add almost $20 billion in new expenditures this year, all of which is so far unaccounted for in the budget. "No government has ever addressed the fiscal mess," he remarked. Instead, successive governments have cut capital expenditures in important areas like irrigation and infrastructure rather than reducing debt and subsidies. Sheth echoed Pan in warning that the biggest problem is the fiscal deficit; successive Indian governments have had five years of growth, but failed to make tough decisions on subsidies and other expenditures, which should have been cut.

¶17. Comment: A recent article in the paper Mint notes that the last time the RBI tightened interest rates - in the mid-1990s, also due to inflation - the impact on growth and equity markets was felt at least a year later, with markets taking a longer time to recover. While India's economy is structurally different than it was 15 years ago, it is possible that growth could continue to slow, and markets could continue to drop, especially if oil prices stay high and FII interest in India take much longer to return. Analysts and companies are resigned to weathering a slower growth period - especially in an election season where fighting inflation will be the main priority - though India's growth will still likely outpace most other countries around the world. End Comment.

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